RESERVE BANK
OF NEW ZEALAND

Financial Stability Report *Highlights*

November 2006

Summary

The Reserve Bank today released its *Financial Stability Report*, a twice-yearly report that assesses the health of the New Zealand financial system. The report covers developments in financial institutions, foreign exchange and debt markets, and payments systems. It also comments on recent financial policy developments.

Banks continue to appear well capitalised and continue to return strong profits. However, banks are competing in an aggressive manner, accepting lower margins and higher risk loans in their efforts to retain and grow market share in mortgage lending.

With the household sector already saddled with considerable mortgage debt, any increased strain to service these debts, such as reduced incomes or higher interest rates, and unexpected decline in house prices, would impact negatively on the quality of banks' balance sheets.

The Reserve Bank will be watching such developments closely, in particular as it implements new capital standards for banks that aim to ensure they have a sufficient buffer against unexpected losses.

The Bank continues to expect the New Zealand economy will rebalance through a gradual slowdown in domestic spending and a reduction in the current account deficit.

However, New Zealanders continue to be heavy users of foreign savings to largely finance housing. This leaves us vulnerable to any change in global perceptions of New Zealand's credit worthiness. A turn for the worse in such perceptions would push New Zealand's longer-term interest rates up and possibly force a more rapid rebalancing in the current account deficit than is comfortable.

The New Zealand foreign exchange market is also experiencing a high level of foreign investor attention as global investors make use of New Zealand's interest rate differentials. Given the inherently cyclical nature of such flows, a shift in expected interest rates globally could lead to an outflow of speculator funds and volatility in the New Zealand dollar exchange rate.

With regard to policy developments, legislation has recently been passed in New Zealand, and is progressing in Australia, that formalises each other having regard to trans-Tasman financial stability when implementing policy.

The legislative changes represent a pioneering step in cross-border banking supervision. They draw a realistic balance between the desirability of trans-Tasman cooperation and the necessary independence of each prudential regulator within their national boundaries.

The material in this report was finalised on 10 November 2006

The economic and financial environment

International

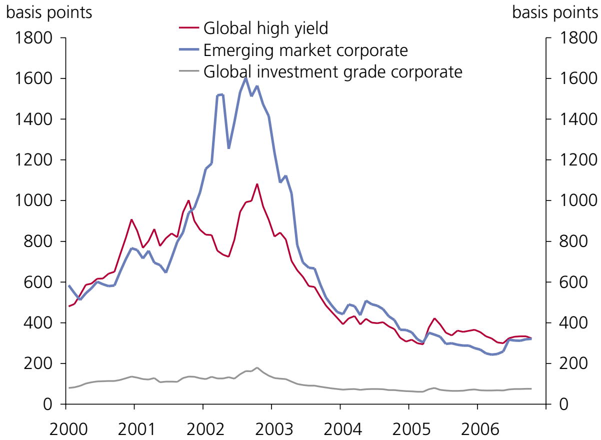
- The global financial system has performed well and is expected to remain stable.
- However, key financial risks remain relevant. These include persistent and large global savings and investment imbalances, and historically low credit spreads (figure 1), which suggest that risk may be under-priced across a number of markets.
- High international house prices, rising levels of household debt servicing costs (figure 2), and rising levels of corporate debt present further challenges.
- Australian house price inflation has increased recently, largely reflecting exceptional growth in Western Australia. Corporate gearing does not appear to be a current threat to Australia's financial stability, but the favourable picture is heavily influenced by the mining industry and hence may mask stress in some sectors.

Domestic

- Risks to New Zealand's economy include a high level of foreign debt, in large part driven by households.
- New Zealand's current account is substantial, at approximately 9.5 percent of GDP. We expect that a slowing economy, and to a lesser extent, a lower exchange rate will help to improve the trade balance in coming years.
- Slowing economic growth has resulted in a more challenging business environment for New Zealand companies. Corporate profit growth has slowed recently, following more than five years of strong growth. Mergers and acquisitions have increased as companies seek to sustain medium-term growth in earnings. This has in turn raised corporate indebtedness.
- Previous Reports have highlighted vulnerabilities in the rural sector. Credit growth to the sector has been supported by growth in land prices, which have increased rapidly in recent years (figure 3).

Figure 1

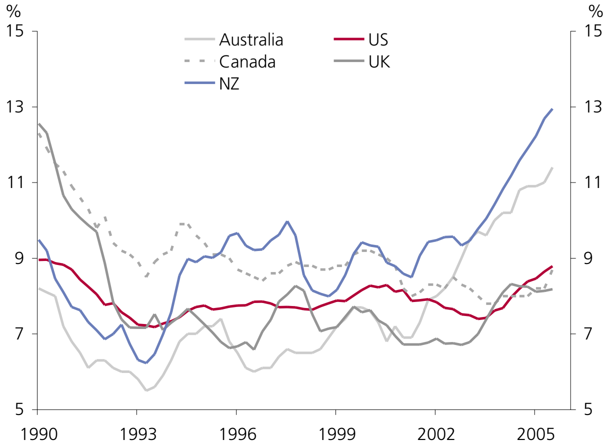
Spreads to US 10 year Treasury bonds



Source: Merrill Lynch, Bloomberg.

Figure 2

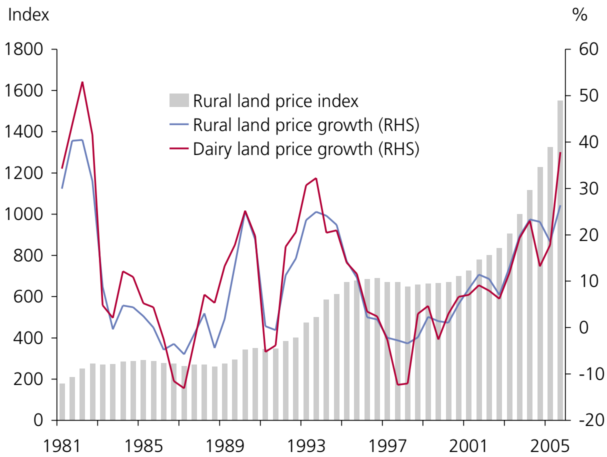
Debt servicing ratios



Source: Australian Bureau of Statistics, Bureau of Economic Analysis, Bank of Canada, Stats Canada, Office for National Statistics, RBNZ.

Figure 3

Rural land prices



Source: Quotable Value New Zealand Ltd.

New Zealand's financial markets

The foreign exchange market

- The NZD market has operated in an orderly manner, but within a relatively wide range. Short-term exchange rate volatility remains somewhat higher than Australian dollar volatility (figure 4).
- Liquidity in the New Zealand dollar (NZD) is very high, reflecting the high level of cyclical interest in NZD investments.
- Such cyclical liquidity is by definition transitory. A rapid reversal of these transitory flows for some unexpected reason would pose challenges to the smooth functioning of the market.
- The value of the NZD appears high relative to some underlying economic fundamentals. In large part this represents strong cyclical demand driven by international investors chasing interest rate differentials. Such a high level of participation in the NZD market makes its level susceptible to any sudden re-pricing of global interest rate market risk premia and monetary policy expectations.
- The level of foreign investment in New Zealand via Uridashi and Eurokiwi bonds, as well as government securities is at historic highs (figure 5).
- There is a relatively high level of Uridashis maturing in the coming year (NZ $10.2 billion). We expect that a significant proportion of the soon-to-mature Uridashi bonds will be rolled over into alternative NZD products, even if the NZD interest rate differential narrows (figure 6).

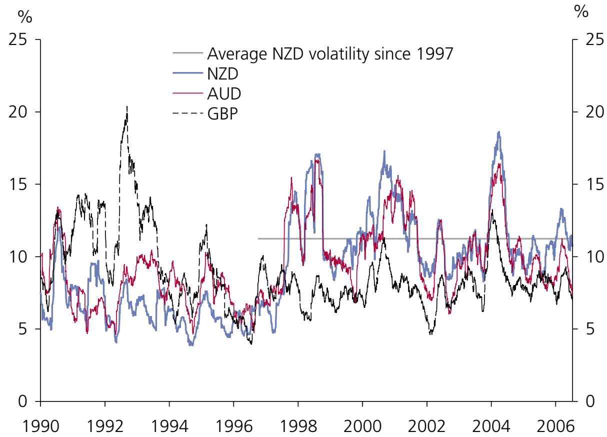
The fixed income markets

- The fixed interest markets has continued to operate satisfactorily, with a very high level of turnover.

  The challenges that exist are similar to those in the foreign exchange markets. The fixed interest markets are presently dominated by offshore market participants who have been attracted by New Zealand's cyclically high interest rates.

Figure 4

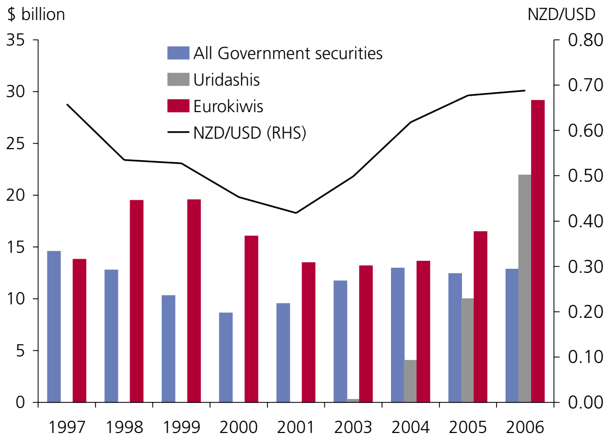
Volatility in the NZD, AUD and British pound



Source: RBNZ.

Figure 5

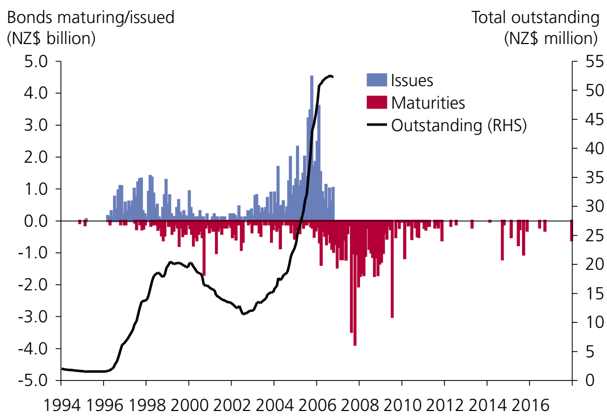
Estimated foreign holdings of selected securities (in NZD)



Source: RBNZ.

Figure 6

Offshore New Zealand dollar denominated bond issuance (Eurokiwi and Uridashi bonds)



Source: RBNZ.

New Zealand's financial institutions

Banks

- Banks' balance sheets continue to grow, underpinned by strong capital positions and good profits.
- Post-tax return on assets increased during the June 2006 quarter, with the ratio remaining above 1 percent. Post-tax return on equity is currently 14.6 percent.
- Figure 7 shows that tier 1 capital and total capital to risk weighted assets are currently above minimum requirements of 4 and 8 percent respectively.
- However, residential mortgage lending is at historic highs despite a slowing economy and very high household debt-gearing (figure 8). This cocktail exposes banks to potential losses stemming from slower growth and higher risk new lending in this area.

Australian parent banks

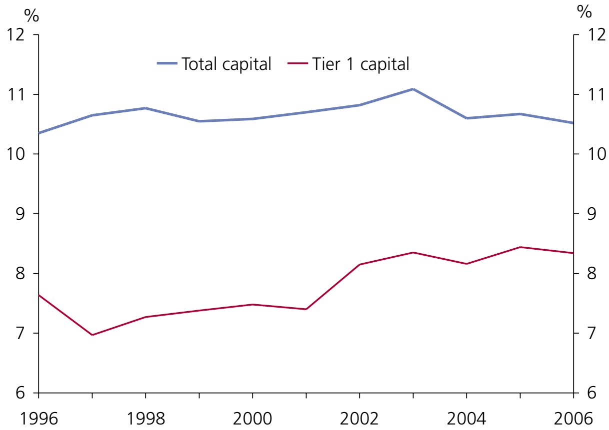
- Australia's banks have performed well, recording strong profits. Profitability has been supported by low levels of bad debts, and capital ratios are comfortably above regulatory requirements.
- As in New Zealand, competition in the sector is strong; attempts to grow group profits through the subsidiaries could increase risks to New Zealand's financial system stability.

Non-bank lending institutions

- There are a large number of non-bank lending institutions – more than 200 – but most are small in comparison to the banks. Figure 9 compares the sizes of non-bank deposit-takers and banks.
- The non-bank deposit-taking sector has continued to grow rapidly in terms of assets, despite the slowdown in the economy and signs of isolated stress in some institutions and sectors (eg the second hand car market). While some deposit-taking finance companies will continue to come under stress, it is unlikely that these isolated incidents will challenge New Zealand's overall financial stability.

Figure 7

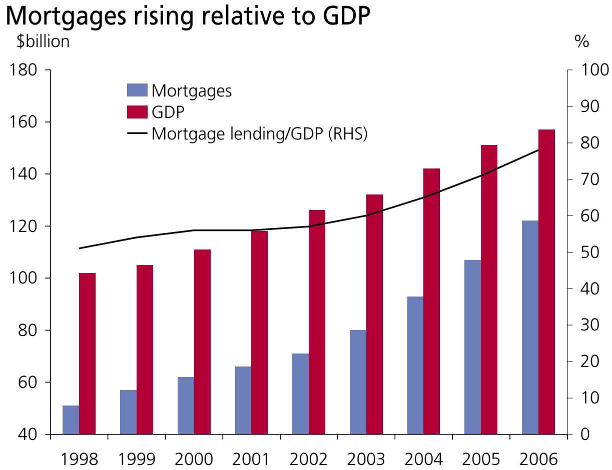
New Zealand banking system capital ratios



Source: Registered banks' GDS, as at 30 June.

Figure 8

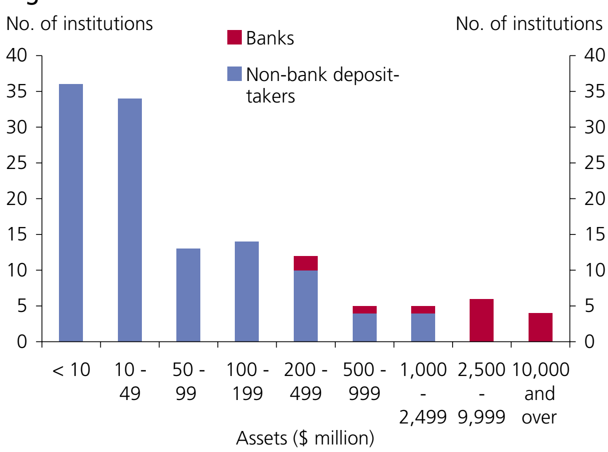
Mortgages rising relative to GDP



Source: Statistics New Zealand and RBNZ registered banks' standard statistical returns (SSR) as at 30 June for mortgage data. GDP to June 2006.

Figure 9

Size distribution of non-bank deposit-takers and registered banks



Source: Registered banks' GDS, RBNZ NBFI SSR and annual non-bank lending institutions returns. Registrar of Friendly Societies and Credit Unions. As at December 2005.

The New Zealand payment system

- The Reserve Bank takes an active interest in the payment system and in recent times has pursued several initiatives designed to reduce payment system related risk.
- These initiatives include the move to real-time gross settlement, delivery-versus-payment in securities settlement, the entry of the New Zealand dollar to the CLS system, and legislative changes to provide for more legal certainty in respect of these processes.
- The Reserve Bank owns and operates two large-value payment systems – the Exchange Settlement and Account System (ESAS) and the Austraclear New Zealand system. Both are systemically important, high-value payment systems. Overall, these systems have performed satisfactorily over the period since the previous *Financial Stability Report*.

Recent developments in financial regulation

- This chapter takes stock of some of the regulatory initiatives that are under way to take advantage of the benefits, and manage the risks, that can come with close trans-Tasman financial integration. We also touch on other developments in New Zealand's financial integration.
- The Reserve Bank is working closely with Australian regulators and officials to ensure the financial stability of both countries is maintained without unnecessary regulatory cost. Legislation has recently been passed in New Zealand and is progressing in Australia that formalises each regulator having regard to trans-Tasman financial stability when implementing policy.
- Implementation of the Reserve Bank's local incorporation policy is now also complete, with the registration of Westpac New Zealand Ltd making all large banks compliant.
- Progress is also being made on the outsourcing policy and the Basel II capital requirements for banks.
- The Government's 'Review of Financial Products and Providers' is proposing enhanced regulation for non-bank deposit-taking institutions. These enhancements are aimed at improving the quality of information available to investors, and promoting more consistent supervision across the non-bank sector.